Austrian Economics, Regime Uncertainty and the New Normal

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Abstract

This paper uses the Austrian School of Economics explanation for the business-cycle to describe the institutional and monetary reasons for the housing bubble and crash which lead to our current Great Recession. I explain the continuance of low economic growth and above-normal unemployment in the United States by government interventions after the financial down-turn which failed to allow Schumpeter's "creative destruction" and asset re-allocation to take place. Then, I use Robert Higgs' concept of "regime uncertainty" to explain why perhaps we are now faced with what the *Economist* magazine terms a "new normal" of lower than historic rates of economic growth in the modern welfare-state. Lastly, I recommend institutional changes which address the concerns raised during the preceding discussion.

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The private sector got us into this mess. The government has to get us out of it.
Barney Frank 2008

Introduction

This paper proposes that we are currently in a new period of history (commonly called the Great Recession) in the United States of America, one that corresponds with a level of Regime Uncertainty not experienced sense the Great Depression of the 1930s. Robert Higgs (2011 and 2013) uses the term Regime Uncertainty to describe a political and institutional climate where *ex ante* capital accumulation is found to be negative due to entrepreneurs' lack of trust in the character of the political leadership of a country. When it is perceived that property rights are not secure investors seeks other outlets for their capital. This then leads to below historic levels of economic growth, and, correspondingly, higher than historic levels of unemployment.

I build a case for this proposition of heightened Regime Uncertainty in the following manner. In the next section of the paper I will present the macroeconomic indicators comparing the Great Recession of today with the latter half of the 20th century showing that we indeed may be in a new period of history, one that the *Economist* calls the New Normal. There are not enough data points to make this argument statistically but I hope that I will make a cogent argument analytically.

Then I will use the Austrian economics explanation for the business-cycle in conjunction with Schumpeter's notion of "creative destruction" to explain how and why we find ourselves in this new period of history. This section too will support the argument for why I am comparing the latter half of the 20th century with today's Great Recession for our macroeconomic indicators.

Finally I will use the analytical arguments presented in the paper to show the necessary institutional reforms which would plausibly allow the United States to move beyond our current period of economic malaise.

The New Normal

I show below a table comparing the historic levels of real economic growth and unemployment in the USA with that of today's Great Recession. Although of course it is too early to tell if indeed we are indeed in a New Normal we do find that we are under a state of lower economic growth and higher unemployment.

Table 1: Historical and New Normal Indicators

	Historically (1951-2000)	Great Recession (2010-2011)
Average Economic Growth	4.3%	2.2%
Average Unemployment	5.5%	9.3%

The figure for historical economic growth is averaged annual data from the Bureau of Economic Analysis and the unemployment figures averaged annual data from the Bureau of Labor Statistics. I have removed from analysis those years declared by the National Bureau of Economic Research to be recession years. The economic growth data for the Great Recession is from the *Economist* magazine (via the BEA). I have labeled the presentation of this data as the New Normal following the *Economist,* who in December 2102 when announcing the 13th straight quarter of economic growth in the United States since the ending of the NBER declared 2007-2009 recession, asked if this new lower growth is the New Normal. (I am happy to make my calculations available upon request.)

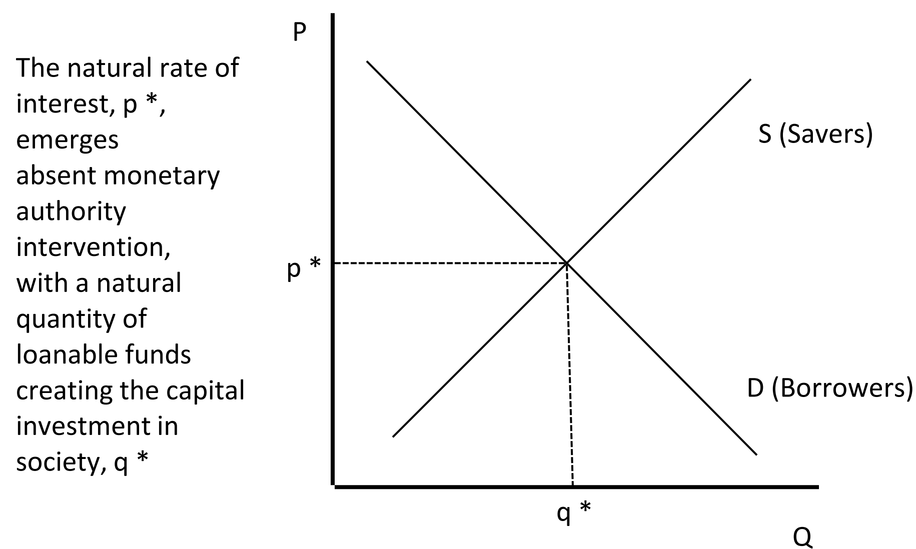
Theoretical Underpinnings of Our Explanation for the New Normal

F.A. Hayek shared the 1974 Nobel Prize in economics for his "Austrian School" monetary explanation of the business-cycle. I will present an encapsulated version of this explanation to facilitate this theory's place in our narrative.

The natural rate of interest and the natural stages of production

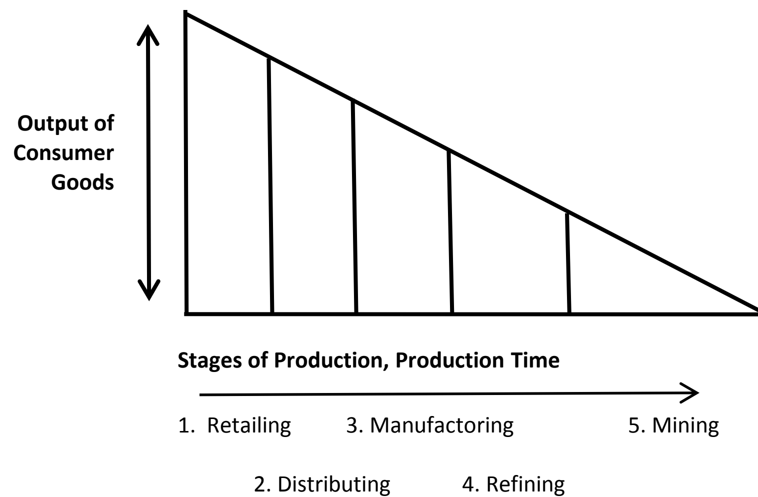
When there is no central monetary authority intervention into the financial markets a “natural” rate of interest evolves in the loanable funds market representing the exchange of time-preferences between society’s savers and borrowers. (In fact there are many natural rates of interest depending on risk class of the debt instrument but I am using an abstracted model to illustrate the point).

Figure 1: Loanable Funds Market Absent Intervention



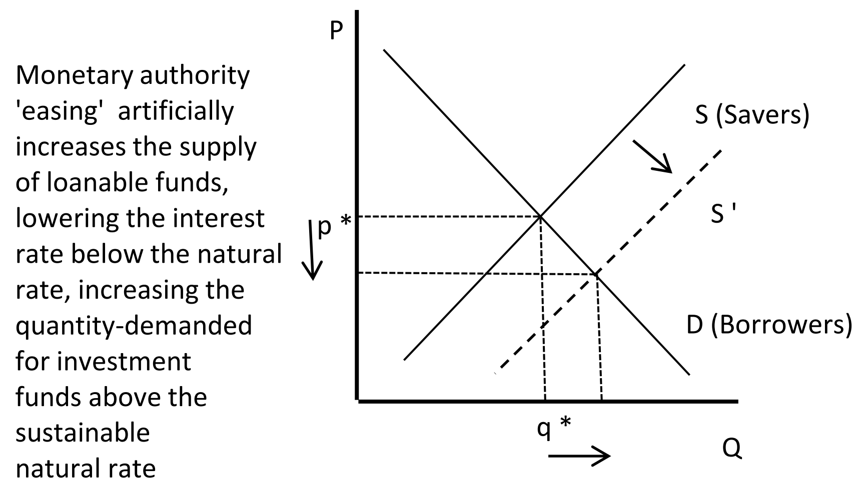
The natural rate of interest and capital investment then over time evolves into society's natural capital structure, with shorter through longer stages of production emerging based on the natural rate of interest sending the price signal for investment decisions to the various economic actors in society. Below we find the natural stages of production. Mining takes the longest time to payback and thus requires long-term capital investment by those with longer, less immediate, time-preferences. Retailing and consumption are almost immediate and are for those with shorter time-preferences.

Figure 2: Stages of Production Absent Intervention



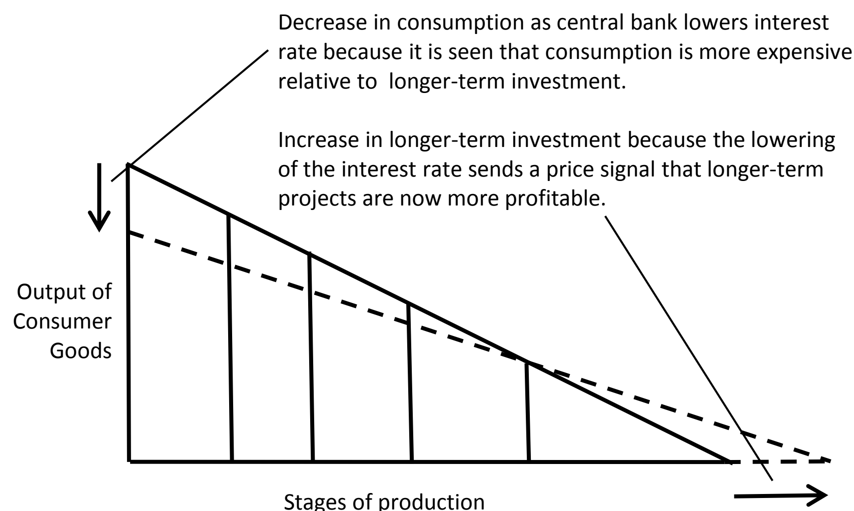
Then we find when the central monetary authority (in the USA the Federal Reserve Bank) uses "monetary easing" in an attempt to encourage economic growth the market rate of interest becomes lower than the natural rate of interest. It appears to society that savings has increased but this is a false price signal, society's time preferences have not changed.

Figure 3: Loanable Funds Market With Intervention



When the interest rate is artificially lowered this sends an artificial price signal to economic actors that long-term investment (like housing mortgages, which are typically 30 years) are now more viable than they were prior to the monetary intervention. More immediate stages of production now seem more expensive relative to longer stages of production so resources are (unsustainably) shifted from shorter time-preference to longer time-preference expenditures. This artificial elongation of time-preferences due to monetary authority intervention can explain asset bubbles during times of monetary easing.

Figure 4: Stages of Production With Intervention



It is well known that monetary easing must end eventually or there will be inflation, and monetary authorities have a mandate to contain inflation. In order to tame inflation the monetary authority reduces monetary easing to where the market rate is above the natural rate. This new, again artificial, interest rate sends signal to economic actors to shorten their time-preferences. The long-term investments which were seen as profitable during times of monetary easing are no longer seen as profitable. The asset bubble is "popped" and investments in these assets need to be reallocated to more profitable uses or the economy will face stagnation.

Creative Destruction

Joseph Schumpeter (1942) introduced *creative destruction* to show that it is not the evenly-rotating economic model of perfect competition which creates material progress under capitalism, rather it is the replacing of old technologies with new technologies which by definition bring about business-cycles. Business-cycles are healthy as they bring to the fore these new technologies during the upswing of the cycle, then allow the destruction of outmoded technologies during the downswing portion of the business-cycle. It is only with these necessary business-cycles, with creative destruction and not with macroeconomic "stability", that economic growth is continued.

I propose that part of the reason for the New Normal of today's Great Recession is that the Federal Reserve's and US government administrations' interventions, perhaps in the name of stability or perhaps in favor of special-interests, after the housing boom and bust, both under President Bush and President Obama, have prevented the reallocation of scarce economic resources towards more productive uses. Furthermore these interventions were not affected with established rules of law nor established historic patterns of behavior. The egregious, extensive and arbitrary nature of these massive interventions have created our current period of Regime Uncertainty, a period of which I propose we will not outgrow without fundamental reform of our current economic institutions. I will now apply the above theoretically underpinnings to our current situation.

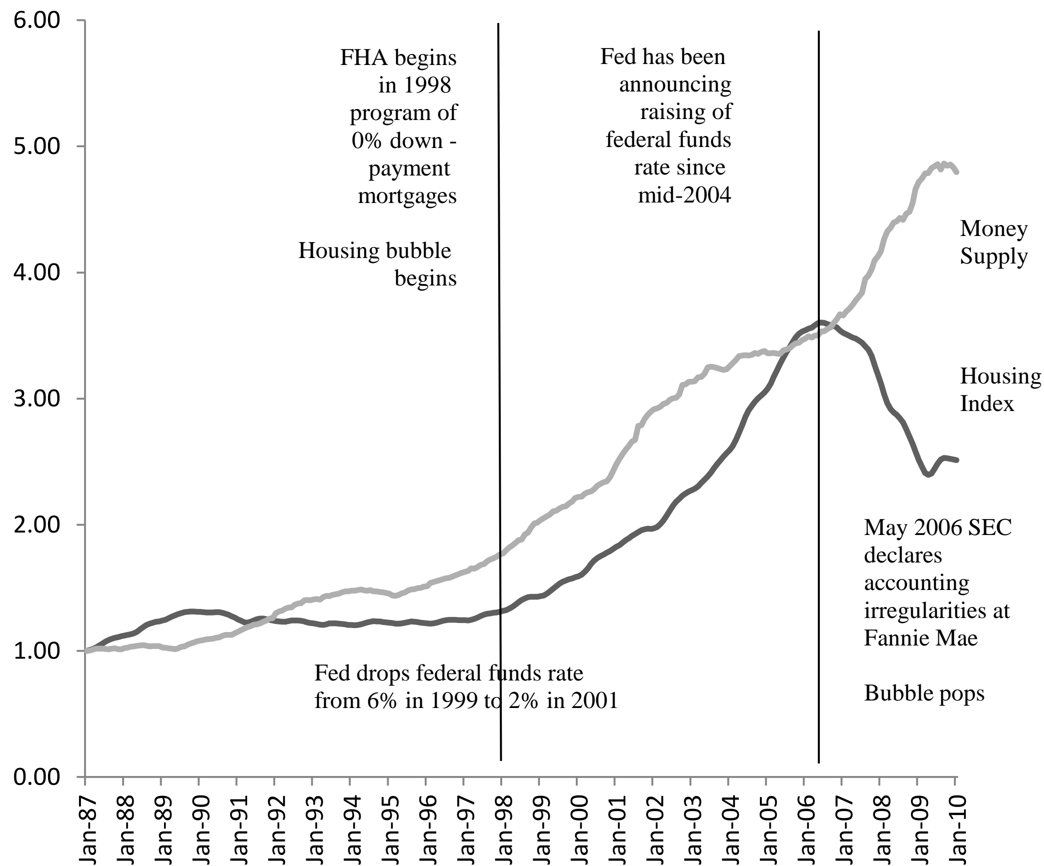
The Housing Boom and Bust of the Early 21st Century

Ever since the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1935 and Federal National Mortgage Association (Fannie Mae) in 1937 the US government has been extensively involved in how and where banks lend for mortgages (see Friedman 2009 for a historic account of these continually deepening interventions and Krueger 1974 on how continual political interventions into the market eventually make the market stop-functioning for the allocation of society's scarce resources). I will use more recent history as an entry-point to describe the institutional and monetary reasons for the housing boom and (semi-) bust leading to today's Great Recession.

Below the reader will find a graph of the money supply ("MZM" as reported by the Federal Reserve) and the price of housing stock in the USA (the Case-Shiller "Composite 10" index). I propose that the housing bubble was triggered by the newly-declared Federal Housing Administration zero-percent-down mortgage policy of 1998, followed by the FHA's declaration in 2000 to have half of the mortgages in the US be to low-income households, and of course with banking

regulation encouraging banks to meet these goals. Around the same time the Fed began an aggressive period of monetary easing, announcing a continual drop in the Federal Funds Rate from 6% in 1999 to 2% in 2001 while at the same time increasing the money supply (as can be seen from Figure 5).

Figure 5: The Housing Bubble and Bust



Using the Austrian school explanation for the business-cycle we can explain the concomitant rise in housing prices and monetary easing: the time-preferences of potential home-buyers were artificially lengthened, away from savings and consumption and towards the long-term investment of a housing mortgage. Needless to say both the easy money and the easy lending terms might be able to help us understand the housing bubble.

However there are additional policy incentives placed on economic actors at the time which may have turned a historically uneventful bubble and bust into today's New Normal. Fannie Mae issued and guaranteed mortgage-backed bonds, again to encourage onward mortgage-lending from the bond proceeds. Fannie Mae was the only stock listed on the NYSE that did not have a clean audit opinion, which some believe is because it was a Government-Sponsored Enterprise (GSE) whose liabilities where implicitly guaranteed by the US government. This in turn meant that these "sovereign" mortgage-back bonds were entitled to be held against fewer reserves, and then more profit through onward lending against less reserves, according to the new international banking standards (Basel II) agreed to by the world's central bankers in 2004. In turn this meant that the issuance of these bonds was encouraged by banks all over the world. Basel II then turned the eventually 'popping' of a by definition an unsustainable bubble into a world-wide financial crisis.

We can see from the graph that the Fed had begun monetary tightening beginning in mid-2004. This effected the time-preferences of those who had taken out mortgages as the mortgages no longer seemed as economic as they did during the time of the rapid monetary easing. With the lag-time expected of any exogenous shock on individual behavior, the housing market peaked in 2006 and a downturn ensued, especially on the subprime mortgages encouraged by the FHA zero down-payment policy.

The reason for the popping of the financial bubble is of course difficult to ascertain with certainty, however I am proposing that it may be the fact that in 2006 the US Securities Exchange Commission (SEC) required a restatement of Fannie Mae's financial statement. This may have sent shock-waves throughout the international financial 'system' (a system created by deposit guarantees, international regulation limiting localized discretion in risk-taking and the adverse incentives towards prudent bank behavior due to the implicit bailouts required under the "too big to fail" doctrine of central banking stability policy). Bankers may have been concerned about the mechanisms for being made whole on the Fannie Mae bonds due to the unauditability of Fan's finances. Following this conjecture, the markets "froze" in August 2007 as subprime mortgages, as encouraged by the FHA policy of 1998, continued to turn sour and as banks did want to take a loss on their Balance Sheets on subprime mortgage bonds, with the Fannie Mae guarantee uncertainty preventing the limitation of down-side risk.

Regime Uncertainty

The reaction to the financial crisis was one of discretionary policy on behalf of US Treasury and Federal Reserve officials in 2007 and 2008. Instead of allowing creative destruction to allow liquidation of the over-investment in housing assets and the reallocation of these assets into more economic investment, the Fed and the Treasury stepped-in with massive monetary interjections and overt bailouts with taxpayer funds. In addition, instead of allowing asset reallocation, the Obama Administration and the Congress, following orthodox Keynesian economics (or self-interest), passed an almost $1 trillion dollar stimulus package in 2009.

The policy reactions to the financial crisis have caused Regime Uncertainty. Lehman Brothers (a large competitor of Goldman Sachs, whose senior partner Hank Paulson was President's Bush's Treasury Secretary in charge of coordinating the Administration's response to the crisis) was allowed to go bankrupt while others, including non-banks like the AIG insurance giant, a massive counter-party to Goldman, received taxpayer bailout money. General Motors too was bailed-out and forcibly-restructured by the Obama Administration (to the benefit of the United Auto Workers, a large Democrat Party campaign contributor, at the expense of private bond-holders).

It was these discretionary actions (and fiscal stimulus too is discretionary political allocation as opposed to market allocation of resources) which created the Regime Uncertainty and New Normal we are continuing to face today. When we add the complex Dodd–Frank Wall Street Reform Act, and the Patient Protection and Affordable Health Care Act of 2010 (placing 17% of the US economy into regulatory limbo for several years), we can see quite clearly why private sector economic activity in the US is facing a period of a prolonged New Normal.

Figure 5 shows a decoupling of real economic activity (in this case housing prices) from that of monetary policy around the time of the 2007 financial crisis, showing what old-school Keynesians called the futility of monetary policy which is "pushing on a string" to no avail. It is not the lack of monetary-easing which is causing the New Normal, it is Regime Uncertainty. In fact, prolonged monetary easing *adds to* Regime Uncertainty in that entrepreneurs are fearful of what the long-term value of US$-based investments will hold as the dollar continues to be devalued.

Needed Institutional Change

It is hoped that the following recommendations for institutional change are self-evident from the narrative above.

1) **Income tax.** The income tax allows write-off on debt and taxes equity twice. This special-interest policy towards the financial sector creates too much debt in the economy, and with it, crises as the Fed manipulates the interest-rate. There should be a flat income (or consumption) tax. A flat-tax applied equally to all follows Hayek's (2011) notion of generality and equality under law. A general and equal tax too will remove the Regime Uncertainty of the "tax the rich" rhetoric of politicians.

2) **Lender-of-Last Resort (LLR) policy.** Given a central bank, the rules for making liquidity available to avoid crisis need to be reigned-in and clarified to prevent special-interest treatment to large well-connected institutions. Liquidity should be made available for short periods of time, for high (penalty) rates of interest and with good collateral. The Fed's discount window should be made available equally to all financial institutions, and only under these conditions, with no exceptions and this should be overtly announced as Fed policy (See Bagehot 1873).

3) **"Too Big To Fail" (2B2F) policy.** The whole idea of 2B2F should be abolished, as this opens the door to special-interest treatment to the politically well-connected and creates unnecessary Regime Uncertainty. With a reformed LLR as noted above, there would be no need for a separate 2B2F.

4) **Inflationary-bias in central bank policy**. Again, given a central bank, the Fed should have a single mandate, price-stability. However, unlike the current price-stability mandate, prices should be able to drop as well as to increase within a given band (say 3% annual aggregate price movements in either an inflationary or deflationary direction). The current upward price-bias in stability policy means that savers are penalized to the advantage of borrowers. Savings provide the capital-base from which investment is made, and only with real investment are standards-of-living able to increase. In addition, inflationary-bias in policy hurts the less wealth-off in that they have less discretionary income to spend on increasingly more expensive goods. The Fed's current dual mandate of both price stability and reducing unemployment through monetary interventions is contradictory.

5) **Housing policy.** The policy of the US government for the last 75 years has been to encourage people to buy homes they are not yet ready to afford. This has been accomplished through Federal Housing Administration policy, the Community Reinvestment Act, and Fannie Mae and Freddie Mac 100% mortgage-backed bond guarantees. This misuse of society's resources discourages entrepreneurial activity and prevents people from moving geographically to find employment.

In addition I would like to make two more recommendations of a more fundamental nature.

6) **Currency Competition.** Allowing competition in currencies would remove the central monetary authority's monopoly on currency issuance. This would prevent the market interest rate from becoming too out of line with the natural rate of interest as competing financial intermediaries develop to meet society's monetary needs. In addition competing currencies would prevent debasement of the currency in that government officials would not want a devaluing tax-base in the State-denominated currency (See Hayek 1990).

7) **Reform of the Social Safety Net.** Currently US Government spending is approximately 25% of US Gross Domestic Product (GDP). Around 15% of GDP is US Government expenditures for corporate- and social-welfare. This means that around 15% of US GDP is based on fixed-prices developed by politicians and bureaucrats (Hayek 1945 speaks of how when prices are not flexible this causes social crisis, in this case our New Normal). If we were to remove all corporate and social welfare we could take these savings and redistribute them equally to every person over the age of eighteen at a level slightly above the poverty rate (see Weber 2013 for more information). In turn, removal of the welfare-state as is and redistribution as a Basic Income would increase economic growth due to increased price signals through exchange in the market.

A Note on Method

This paper is an exercise in explanatory social science, specifically one of explanatory critique. I began with the stylized facts of a proposed New Normal of reduced economic growth and increased unemployment in the modern welfare-state of the USA. Using plausible reasoning I then traced back the social and economic institutions which lead to the current state of events. Finally I then propose the institutional changes needed to correct the current state of affairs, which I have found to be unacceptable for the good of society as outlined in the explanatory critique.

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